



**COUNTY OF LOS ANGELES  
DEPARTMENT OF AUDITOR-CONTROLLER**

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ALAN T. SASAKI  
AUDITOR-CONTROLLER

January 25, 2000

To: Supervisor Gloria Molina, Chair  
Supervisor Yvonne Brathwaite Burke  
Supervisor Zev Yaroslavsky  
Supervisor Don Knabe  
Supervisor Michael D. Antonovich

From: Alan Sasaki  
Auditor-Controller

Subject: **1998-99 Community Health Plan Financial Audit**

Attached is a copy of the independent auditor's report and management letter for the 1998-99 Community Health Plan (CHP) Financial Audit. The audit was performed by Brown Armstrong Randall & Reyes Accountancy Corporation (Brown Armstrong).

The California Code of Regulations (Knox-Keene Health Care Plan Act) require CHP and other Knox-Keene Plans to submit annual statements of financial activity, that have been audited by an independent certified public accountant, to the State Department of Corporations. The statements must be accompanied by an opinion on the fairness of the financial statement presentation.

Brown Armstrong expressed an unqualified opinion on the CHP's financial statements as of June 30, 1999. CHP has submitted the report to the Department of Corporations, as required.

Brown Armstrong's Reports on Compliance and Internal Control over financial reporting noted the following reportable conditions:

- CHP does not have an effective system to process claims accurately and timely as required by the California Health and Safety Code.
- CHP does not have a formal policy for reviewing the accuracy of estimates for health care expenses on a periodic basis.

Brown Armstrong also identified several weaknesses in the CHP's internal control structure. These issues were discussed with management and are included in the auditor's "Communication With Management," which is enclosed in the Reports on Compliance and Internal Control.

CHP stated that they have taken or are taking actions to correct the reportable conditions and weaknesses in the internal control structure.

If you have any questions, please contact me.

AS:MDC:KM

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c:     Chief Administrative Office  
          David E. Janssen, Chief Administrative Officer  
          Public Information Officer  
          Executive Officer, Board of Supervisors  
          Audit Committee (6)  
          Department of Health Services  
          Dave Beck, Office of Managed Care  
          Sachi Hamai, Inspection & Audit

**COMMUNITY HEALTH PLAN  
LOS ANGELES, CALIFORNIA**

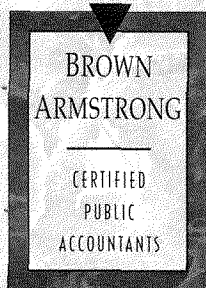
**REPORTS ON COMPLIANCE AND  
INTERNAL CONTROL**

**JUNE 30, 1999**

**COMMUNITY HEALTH PLAN  
REPORTS ON COMPLIANCE AND INTERNAL CONTROL  
JUNE 30, 1999**

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**BROWN ARMSTRONG  
RANDALL REYES PAULDEN & McCOWN**  
CERTIFIED PUBLIC ACCOUNTANTS

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Jacqueline L. Anton, CPA  
Joan M. Anderson, CPA  
Bradley M. Hankins, CPA  
Julianne V. Sawyer, CPA  
Eric H. Xin, CPA

**REPORT ON COMPLIANCE AND ON INTERNAL CONTROL  
OVER FINANCIAL REPORTING BASED ON AN  
AUDIT OF FINANCIAL STATEMENTS PERFORMED IN  
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

To the Board of Supervisors of the  
County of Los Angeles, California

We have audited the financial statements of the Community Health Plan (CHP) as of and for the year ended June 30, 1999, and have issued our report thereon dated November 5, 1999. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Community Health Plan's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance that is required to be reported under *Government Auditing Standards*, which is described in the accompanying schedule of reportable conditions.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Community Health Plan's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Community Health Plan's ability to record, process, summarize and report financial data consistent with the assertions of management in the general purpose financial statements. The reportable conditions are described in the accompanying schedule of reportable conditions.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation of the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable conditions described above to be material weaknesses. We also noted other matters involving the internal control over financial reporting that we have reported to management of the Community Health Plan in a separate letter dated November 5, 1999.

This report is intended solely for the information and use of management, others within the organization, and the Board of Supervisors and is not intended to be and should not be used by anyone other than these specified parties.

BROWN ARMSTRONG RANDALL  
REYES PAULDEN & McCOWN  
ACCOUNTANCY CORPORATION

A handwritten signature in black ink, appearing to read "Barry J. Brown". The signature is fluid and cursive, with a large initial "B" and a long, sweeping underline.

Bakersfield, California  
November 5, 1999

**COMMUNITY HEALTH PLAN  
REPORTABLE CONDITIONS  
JUNE 30, 1999**

**Current Year Findings and Recommendations**

**Finding 1. Compliance - Claims Processing System**

Community Health Plan does not have an effective system to process claims accurately and in a timely manner as required by California Health and Safety Code Section 1371. As a result, CHP has to make interim payments and prepayments for certain claims so that CHP will be in compliance with the Health and Safety Code requirements. The infrastructure, personnel, internal controls and current computer systems (administrative capacity) in place at CHP are not able to keep up with the projected growth of CHP.

**Recommendation**

CHP needs to review its current computer system, to hire and train additional claims processors, to obtain more office space, and to improve its internal control and procedures over claims processing so that it can process claims accurately and in a timely manner.

**Management Response**

CHP management agrees that the administrative capacity in the past negatively impacted the Plan's ability to process medical service claims in a timely manner. However, this condition has been corrected. CHP obtained final Board authority to hire an additional thirteen permanent, full-time claims processing-related positions in September 1999 and has filled the new positions. CHP is developing a comprehensive claims processing policy and procedures manual which will be issued to claims processing staff. Claims processing internal controls will also be strengthened.

Additional space has been identified, and a lease proposal will be submitted to the Board of Supervisors in early 2000 for approval.

**Finding 2. Internal Control - Estimates for Health Care Expenses**

Community Health Plan (CHP) does not have a formal policy for reviewing the accuracy of estimates for health care expenses on a periodic basis. As a result, the financial statements required material auditor's adjustments in order to be fairly presented in accordance with generally accepted accounting principles.

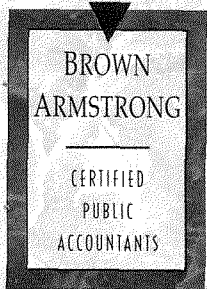
**Recommendation**

CHP should review its policies and procedures for reviewing the accuracy of estimates on a periodic basis. CHP should consider the following procedures:

- Review of the estimates, at least on a quarterly basis.
- The review should include a comparison of actual expense incurred versus estimated expenses. The comparison should also include analysis of expenses per member per month.
- Consider additional staff required to perform the periodic review on a timely basis.

**Management Response**

CHP agrees with this recommendation and initiated an analysis of the reserve liability accounts. The initial analysis should be completed shortly, and will include prior and current year withholds as well as the corresponding expenditures. The analysis will also include appropriate per member per month (PMPM) calculations and recommendations for more closely synchronizing withholds to estimated expenditures.



**BROWN ARMSTRONG  
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**COMMUNICATION WITH MANAGEMENT**

**To the Board of Supervisors of the  
County of Los Angeles, California**


Andrea Rutherford-Hill, CPA  
Steven R. Starbuck, CPA  
Aileen Keeter, CPA  
Lynn R. Krausse, CPA  
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Bradley M. Hankins, CPA  
Julianne V. Sawyer, CPA  
Eric H. Xin, CPA

**We have audited the financial statements of Community Health Plan for the year ended June 30, 1999 and have issued our report thereon dated November 5, 1999. In planning and performing our audit of the financial statements of Community Health Plan we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. We also considered compliance with laws and regulations in accordance with Government Audit Standards issued by the GAO.**

**During our audit, we noted agreed-upon conditions involving the internal control structure. These comments and recommendations, all of which have been discussed with the appropriate members of management, were intended to improve the internal control structure or result in other efficiencies and are described in the attached findings and recommendations.**

**This letter is intended solely for the information and use of management, others within the organization, the Board of Supervisors and is not intended to be and should not be used by anyone other than these specified parties.**

**BROWN ARMSTRONG RANDALL  
REYES PAULDEN & McCOWN  
ACCOUNTANCY CORPORATION**

  
By: Benjamin P. Reyes

**Bakersfield, California  
November 5, 1999**



**COMMUNITY HEALTH PLAN  
AGREED-UPON CONDITIONS  
JUNE 30, 1999**

**Current Year Findings and Recommendations**

**Finding 1. Estimated Health Care Services Reserve**

The estimated liabilities for drugs and medicine, medical services, and medical supplies are recorded in one account (account #2410 Health Care Services Reserve) making it unnecessarily difficult to determine which estimate for health care services is excessive or deficient.

**Recommendation**

CHP should establish separate general ledger liability accounts for drugs and medicine, medical services, and medical supplies to facilitate the evaluation of estimates.

**Management Response**

Although CHP's accounting system has the capability of identifying which health care services reserves are excessive or deficient through the generation of a report, CHP management agrees with the recommendation and for fiscal year 1999/2000 is establishing separate general ledger liability accounts for each type of health care service reserve.

**Finding 2. Error with Claims Processing System**

During our test of controls over claims processing system, we noted that one of the claims was not paid with an appropriate hospital reimbursement rate. Further discussion with management led us to believe that the cause is that CHP has not updated its inpatient reimbursement schedule on a timely basis.

**Recommendation**

CHP should update its reimbursement rates in the Patient Management System on a regular basis and check the system occasionally to ensure that the System calculates claims correctly.

**Management Response**

CHP agrees with this recommendation, and with the additional staff to carry on the day to day operations. Supervisory and management staff can now focus efforts on internal and quality controls which should resolve problems such as use of out-dated reimbursement rates.

**Finding 3. Misplaced Claim Files**

CHP was not able to locate six claims file out of our sixty claims disbursement testing samples so that we were not able to perform our testing. Further discussion with management indicates that CHP has had inadequate space and manpower to handle its increased volume of claims.

**Recommendation**

CHP should develop an organization system to maintain claim files and other original accounting records under current situation. In the meantime, CHP should consider obtaining additional working and storage space as well as employees in response to the rapid growth of its business.

**Management Response**

CHP agrees with the recommendation and has revised its organization system to better maintain claim files. The inability to locate the six files appears to be related to the temporary filing method used during efforts to clear a large claims backlog. Staff now file claims on the date completed. These claims are now archived as they are completed, and the retrieval process is as simple as querying the Patient Management System for the date completed, and then locating the file in the proper storage container. The revampment of our filing system should minimize much of the manual sorting and re-sorting of claims.

**COMMUNITY HEALTH PLAN  
AGREED-UPON CONDITIONS  
JUNE 30, 1999**

**Finding 4. Unskilled Claims Processor**

During our claims disbursement testing, we noted one instance of procedure code modifier claim mistakenly paid at the regular rate instead of at the Medi-Cal rental rate. Further discussion with management indicates that certain claims processors are unfamiliar with modifiers.

Recommendation

CHP should train and cross-train all claims processors to be aware of procedure code modifiers. In addition, double check by other processors and review by supervisors should be enforced.

Management Response

As stated in "Reportable Conditions - Finding 1", once CHP has completed its revised procedures for claims processing and its policies for internal control, it will be in a position to better train and cross-train all claims processors and more effectively review their work product.

**COMMUNITY HEALTH PLAN  
AGREED-UPON CONDITIONS  
JUNE 30, 1999**

**Status of Prior Year Findings and Recommendations**

**Finding 1. Miscoding of Claims**

During our testing of accounts receivable from county facilities and contract providers for in-area out-of-plan claims, we noted 5 claims of the 174 tested were inappropriately included as receivables. Those claims were out-of-area out-of-plan claims for which CHP was financially responsible but the service providers were erroneously coded as in-area in the PMS system. The effect of this miscoding is that the receivables and the health care risk pool accounts may be overstated by the amount of miscoded claims.

**Recommendation**

The auditor recommends that CHP review and correct the coding of service providers and perform a periodic review of the coding, especially as new providers are added or if there are changes to the plan.

**Management Response**

CHP agrees with the recommendation. CHP plans to implement a new computer system in July 1999. This new computer system will automatically distinguish between in-area and out-of-area medical claims and the need for manual coding will be eliminated.

**Current Year Status**

Although a new computer system has not been acquired, the CHP developed a stand-alone computer application and procedure to appropriately identify medical service claims which are the responsibility of the CHP's capitated providers. Elements of that application were presented to the auditors as part of their financial review.

**Finding 2. IBNR Calculation**

The calculation of incurred but not reported (IBNR) claims is performed utilizing a claims received lag study. The methodology works well assuming consistency in factors such as the plan's financial responsibility, the claim amounts, demographics of its members, and the turnaround period between the date of service, the claim submittal date, and the payment date. Changes in the factors without the necessary adjustments in the calculation could lead to inaccurate amounts reported for medical expenses and IBNR reserve balance. Inaccurate IBNR calculations could significantly jeopardize CHP's ability to gauge its financial health and results of operations.

**Recommendation**

The auditor recommends that CHP perform studies to evaluate aberrations and changes in claims and the flow of claims, and factor such considerations in the calculation of IBNR. The auditor also recommends that CHP have its IBNR reviewed by a qualified actuary on a periodic basis and at the end of its fiscal year.

**Response**

CHIP agrees with the recommendation. The Office of Managed Care previously retained a consulting firm to assist in a study of capitation rates and actuarial analysis, and recently had followed-up discussions on a proposed project for additional assistance in IBNR methodologies for medical and pharmacy costs.

**Current Year Status**

No actuarial study has been performed over CHP's IBNR.

**COMMUNITY HEALTH PLAN  
AGREED-UPON CONDITIONS  
JUNE 30, 1999**

**Status of Prior Year Findings and Recommendations**

**Finding 3. Reconciliation of Capitation Revenues with Member Enrollment**

The manual reconciliation of member eligibility and monthly capitation produces variances each month that are recorded as a liability at the end of the fiscal year.

**Recommendation**

CHP needs to fully automate the process of the member eligibility reconciliation, retroactive enrollment and disenrollments, and capitation receipt and distribution to ensure that all members and capitation is properly accounted for.

**Response**

CHP agrees with the recommendation. The Office of Managed Care is currently evaluating another managed care information computer system to automate the above functions. Implementation is tentatively scheduled for July 1999.

**Current Year Status**

The Department of Health Services continues to evaluate managed care information system replacement options and had planned to implement a replacement system in January 1999. However, the acquisition of the new system was postponed, and in the interim, CHP will continue to use the Patient Management System.

Although CHP has not implemented an automated process of member eligibility reconciliation, retroactive enrollments and disenrollments (adds and deletes), and capitation receipt and distribution, it is able to reconcile member eligibility and monthly capitation.

OMC Finance will continue to work with OMC information systems support to resolve this issue.

**Finding 4. Deficiencies in the Patient Management System**

CHP needs to use a fully integrated General Ledger to interface with the Patient Management System (PMS). The current General Ledger system requires the manual input of claims data based on PMS information. The manual input of claims data is time consuming and can result in data entry errors.

**Recommendation**

CHP should use the PMS general module or another fully integrated software program that meets its needs. Such a system will reduce the risk of human data entry errors, provide a better audit trail for transactions, and allow for better analysis of accounts.

**Response**

CHP agrees with the recommendation and are currently evaluating integrated software general ledger packages to interface with the new system.

**Current Year Status**

Efforts are currently underway to identify a suitable replacement for the CHP PMS. The general ledger available with the PMS is, by admission of the software vendor, completely unusable for a prepaid health plan. Until the CHP has a viable, fully integrated replacement system, it has no choice but to continue with some manual functions.

#### **Finding 5. Ability to Handle Increased Growth**

The infrastructure, personnel, internal controls and current computer systems (administrative capacity) in place at the CHP may not be able to keep up with the projected growth of CHP. Many of the processes of CHP are manually intensive, e.g. calculation of capitation and IBNR. The internal checks and balances necessary for a strong internal control environment are inadequate due to limited staffing arrangements.

##### Recommendation

CHP needs to automate its manual intensive processes as quickly as possible in order to remain competitive in the managed care market and handle the projected growth of the plan

##### Response

CHP agrees with the recommendation. As stated above, the Office of Managed Care is evaluating a new managed care information system to replace the system currently in use. This new system should eliminate the manual processes identified in this recommendation.

##### Current Year Status

As stated in "Reportable Conditions - Finding 1", CHP has hired additional personnel to carry out timely claims processing functions. CHP is expected to replace the current PMS. However, as of this report no suitable replacement system has been identified.

#### **Finding 6. Year 2000 Compliance**

The MIS department is performing year 2000 compliance assessment and testing on the Patient Management System. Certain potential problems have been identified through previous tests and corrected by the vendor. The PMS' training module was found to be year 2000 compliant when tested with dummy data, but a full test is yet to be performed on the PMS. The operating system in which PMS operates also needs to be upgraded in order to be year 2000 compliant.

##### Recommendation

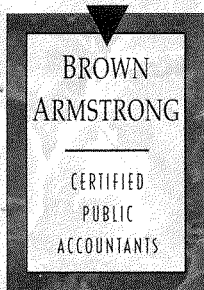
The auditor recommends that CHP continue its efforts to assess, correct or upgrade its systems and software for year 2000 compliance.

##### Response

As stated above, the Office of Managed Care is evaluating a new managed care information system to replace its current system. The new system is year 2000 compliant.

##### Current Year Status

CHP is still working on year 2000 compliance testing as of November 5, 1999.



**BROWN ARMSTRONG  
RANDALL REYES PAULDEN & McCOWN**  
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**COMMUNICATION TO THE BOARD OF SUPERVISORS IN  
ACCORDANCE WITH STATEMENT OF  
AUDITING STANDARDS NUMBER 61**

**To the Board of Supervisors of the  
County of Los Angeles, California**

Andrea Rutherford-Hill, CPA  
Steven R. Starbuck, CPA  
Aileen Keeter, CPA  
Lynn R. Krausse, CPA  
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Joan M. Anderson, CPA  
Bradley M. Hankins, CPA  
Julianne V. Sawyer, CPA  
Eric H. Xin, CPA

We have audited the financial statements of Community Health Plan (CHP) for the year ended June 30, 1999, and have issued our report thereon dated November 5, 1999. Professional standards require that we provide you with the following information related to our audit.

**Our Responsibility under Generally Accepted Auditing Standards**

Our responsibility, as described by professional standards, is to plan and perform our audit to obtain reasonable, but not absolute, assurance that the financial statements are free of material misstatement and are fairly presented in accordance with generally accepted accounting principles. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is a risk that material errors, irregularities, or illegal acts, including fraud and defalcations, may exist and not be detected by us.

As part of our audit, we considered the internal control of Community Health Plan. Such considerations were solely for the purpose of determining our audit procedures and not to provide any assurance concerning such internal control.

**Significant Accounting Policies**

Management has the responsibility for selection and use of appropriate accounting policies. In accordance with the terms of our engagement letter, we will advise management about the appropriateness of accounting policies and their application. The significant accounting policies used by CHP are described in Note 1 to the financial statements. No new accounting policies were adopted and the application of existing policies was not changed during the fiscal year. We noted no transactions entered into by the CHP during the year that were both significant and unusual, and of which, under professional standards, we are required to inform you, or transactions for which there is a lack of authoritative guidance or consensus.

#### Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were management's estimates of estimated medical claims payable and accrued health care expenses, which were based on the historical studies of claims received and experience. We evaluated the key factors and assumptions used to develop the above mentioned estimates in determining that it is reasonable in relation to the financial statements taken as a whole.

#### Significant Audit Adjustments

For purposes of this letter, professional standards define a significant audit adjustment as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. These adjustments may include those proposed by us but not recorded by the CHP that could potentially cause future financial statements to be materially misstated, even though we have concluded that such adjustments are not material to the current financial statements. We proposed certain audit adjustments that were agreed to by management in the areas of estimated claims payable and accrued health care expense.

#### Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

#### Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Company's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

#### Issues Discussed Prior to Retention of Independent Auditors

No issues were discussed prior to the audit that were a condition to our retention as the Company's independent auditors.

#### Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

#### Other Communications

The year 2000 (Y2K) issue is the result of shortcomings in many electronic data-processing systems and other equipment that may adversely affect operations in the year 1999 and beyond. Problems affecting a wide range of governmental activities will likely result if computers and other electronic equipment that are dependent upon date-sensitive coding are not corrected. These problems have the potential for causing a disruption to some government operations and may temporarily increase the cost of those operations. It is our understanding that Community Health Plan has and continues to take steps necessary to minimize interruptions in data-processing systems that may result from the Y2K issue. However, we were not able to provide assurance that CHP is or will be successful in whole or in part, or that parties with which the CHP does business will be Y2K ready.

This information is intended solely for the use of the Board of Supervisors, and management of Community Health Plan and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record, and its distribution is not limited.

BROWN ARMSTRONG RANDALL  
REYES PAULDEN & McCOWN  
ACCOUNTANCY CORPORATION

A handwritten signature in black ink, appearing to read 'B. P. Reyes', written over the company name.

By: Benjamin P. Reyes

Bakersfield, California  
November 5, 1999

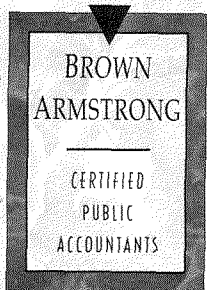


**COMMUNITY HEALTH PLAN**  
**FINANCIAL STATEMENTS**  
**WITH**  
**INDEPENDENT AUDITOR'S REPORT**  
**FOR THE YEAR ENDED JUNE 30, 1999**

**COMMUNITY HEALTH PLAN  
JUNE 30, 1999**

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**BROWN ARMSTRONG  
RANDALL REYES PAULDEN & McCOWN**  
CERTIFIED PUBLIC ACCOUNTANTS

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**INDEPENDENT AUDITOR'S REPORT**

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Burton H. Armstrong, CPA  
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Julianne V. Sawyer, CPA  
Eric H. Xin, CPA

To the Board of Supervisors of  
the County of Los Angeles

We have audited the accompanying balance sheet of the Community Health Plan as of June 30, 1999 and the related statement of operations and changes in fund balance, and cash flows for the year then ended. These financial statements are the responsibility of the Community Health Plan's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only Community Health Plan, a division of the County of Los Angeles Department of Health Services (DHS), and are not intended to present fairly the financial position of the County of Los Angeles, California, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Community Health Plan as of June 30, 1999, and the results of its operations, changes in its fund balance, and its cash flows for the year then ended in conformity with generally accepted accounting principles.

**BROWN ARMSTRONG RANDALL  
REYES PAULDEN & McCOWN  
ACCOUNTANCY CORPORATION**

Bakersfield, California  
November 5, 1999

**COMMUNITY HEALTH PLAN  
BALANCE SHEET  
JUNE 30, 1999**

**ASSETS**

Current Assets

Pooled cash and investments	\$ 26,193,937
Accounts receivable	9,545,700
Interest receivable	545,405
Reinsurance recoveries receivable	1,157,624
Due from other L.A. County funds	238,508
Capitation premium receivable	298,051
Prepaid medical claims	<u>3,671,601</u>

Total Current Assets 41,650,826

Other Assets

Prepaid contract costs	277,772
Restricted investments	<u>303,167</u>

Total Other Assets 580,939

TOTAL ASSETS \$ 42,231,765

**LIABILITIES AND FUND BALANCE**

Current Liabilities

Accounts payable and other accrued liabilities	\$ 1,357,457
Estimated medical claims payable	8,115,912
Accrued health care expenses	13,107,483
Due to other L.A. County funds	<u>6,139,880</u>

Total Current Liabilities 28,720,732

Fund Balance 13,511,033

TOTAL LIABILITIES AND FUND BALANCE \$ 42,231,765

The accompanying notes are an integral part of these financial statements.

**COMMUNITY HEALTH PLAN  
STATEMENT OF OPERATIONS  
AND CHANGES IN FUND BALANCE  
FOR THE YEAR ENDED JUNE 30, 1999**

Premiums	\$ 90,184,902
Cost of Medical Care Provided	<u>77,674,020</u>
	<u>12,510,882</u>
General and Administrative	
Salaries and employee benefits	3,504,798
Service and supplies	2,884,890
Amortization	333,336
Repair and maintenance	74,130
Marketing	<u>229,358</u>
Total General and Administrative	<u>7,026,512</u>
Operating Income	5,484,370
Non-Operating Income	
Interest income	<u>1,567,642</u>
Net Income	<u>7,052,012</u>
Fund Balance, beginning of year	3,614,798
Prior period adjustment	<u>2,844,223</u>
Fund Balance, beginning of year - as adjusted	<u>6,459,021</u>
Fund Balance, end of year	<u><u>\$ 13,511,033</u></u>

The accompanying notes are an integral part of these financial statements.

**COMMUNITY HEALTH PLAN  
STATEMENT OF CASH FLOWS  
FOR THE YEAR ENDED JUNE 30, 1999**

Cash Flows from Operating Activities	
Operating income	\$ 5,484,370
Prior year adjustments	2,844,223
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Operating Activities:	
Depreciation	10,386
Amortization	333,336
Changes in operating assets and liabilities:	
Decrease (increase) in interest receivable	(141,889)
Decrease (increase) in accounts receivable	(7,654,821)
Decrease (increase) in due from other LA County fund	(163,623)
Decrease (increase) in capitation premium receivable	2,573,501
Prepaid medical claims expenses	(3,671,601)
Restricted investments	(987)
Decrease (increase) in notes receivable	500,000
Increase (decrease) in accounts payable	(2,096,566)
Increase (decrease) in accrued expenses	5,526,407
Increase (decrease) in estimated medical claims payable	5,036,275
Increase (decrease) in due to other LA County fund	<u>4,635,648</u>
Net Cash Provided by Operating Activities	<u>13,214,659</u>
Cash Flows from Investing Activities	
Interest income	<u>1,567,642</u>
Net Increase in Cash	14,782,301
Cash Balance, beginning of year	<u>11,411,636</u>
Cash Balance, end of year	<u>\$ 26,193,937</u>

The accompanying notes are an integral part of these financial statements.

**COMMUNITY HEALTH PLAN  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 1999**

**NOTE 1 - ORGANIZATION**

The Community Health Plan (CHP) is the Medi-Cal health maintenance organization (HMO) of the County of Los Angeles Department of Health Services (DHS). It is a federally qualified HMO and is licensed as a prepaid full service health care service plan by the State of California Department of Corporations under the Knox-Keene Health Care Service Plan Act of 1975.

CHP arranges for the provision of health care for Medi-Cal beneficiaries under service agreements with the State of California Department of Health Services (State) prior to May 1, 1997 and with Local Initiative Health Authority (L.A. Care) beginning May 1, 1997. L.A. Care is part of the State's two-plan model to provide specified Medi-Cal benefits to certain categories of Medi-Cal recipients within managed care plans. On February 11, 1997, CHP entered into a service agreement with L.A. Care as a subcontractor to arrange for the provision of health care services for L.A. Care enrollees.

**NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Proprietary Fund Accounting** - CHP utilizes the proprietary fund method of accounting whereby revenue and expenses are recognized on the accrual basis. Substantially all revenues and expenses are subject to accrual.

**Accounting Standards** - Pursuant to Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, CHP has elected to apply the provisions of all relevant pronouncements of the Financial Accounting Standards Board (FASB), including those issued after November 30, 1989.

**Concentration of Source of Revenues** - CHP received approximately 97.8% of its premium revenues under its service agreements with L.A. Care and the State for the fiscal year ended June 30, 1999.

**Pooled Cash and Investments** - CHP participates in the County pooled investment fund. Funds on deposit are pooled with other departments and managed by the County Treasurer. Because funds are highly liquid and readily available for use by CHP, they are classified as pooled cash and investments in the accompanying balance sheets. Interest earned on pooled investments is allocated to CHP's account based upon the account's average daily balance. The average annual interest rate earned on CHP's deposits during fiscal year 1999 was approximately 5.9%. At June 30, 1999, substantially all investments in the County investment pool were U.S. government securities, bankers' acceptances and negotiable certificates of deposit.

**Restricted Investments** - Restricted investments consist of marketable securities which are recorded at amortized cost.

## **NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

**Premiums and Medical Care Expenses** - CHP's premium revenues are primarily capitation payments received for plan enrollees on a per member per month basis. Premiums are recognized as revenue in the month in which the members are entitled to service.

CHP contracts with various County and private hospitals and clinics to provide health care services to its members. The cost of medical care includes capitation payments to contracted hospitals and clinics (in-plan health care providers), provisions for claims from other hospitals and clinics for out-of-area services (out-of-area out-of-plan health care providers), provisions for tertiary care and pharmaceutical supplies, as well as an estimate of out-of-plan services which have been incurred but not yet reported. Cost of capitation payments are recognized in the period enrollees are eligible for service. Provisions for out-of-area out-of-plan claims, tertiary care and pharmaceutical supplies are based on a percentage of premium revenue. The appropriate medical care expenditure accounts and the health care risk pool liability account are increased in the period the capitation payments are recognized. As claims for out-of-area out-of-plan medical services, tertiary care and pharmaceutical supplies are received and the payable amounts determined, the payable amounts are reclassified from the health care risk pool account to accounts payable. If actual claims exceed the liability for the provisions, the appropriate medical care expense accounts are then charged. The estimate of out-of-plan services which have been incurred but not yet reported is based on historical studies of claims received.

**Claims Processed on Behalf of Healthcare Providers** - CHP processes claims on behalf of various healthcare providers who are paid by CHP on a capitated basis. CHP records a liability for all claims processed, including claims that are the responsibility of the providers. For such claims, CHP records a receivable from the various healthcare providers.

**Reinsurance Coverage** - Prior to May 1, 1997, CHP purchased reinsurance coverage from the State for individual Medi-Cal enrollee medical claims paid in excess of \$75,000 per year. Reimbursement is based on allowable charges as determined by the State. The cost of such reinsurance coverage is incorporated into the State's capitation rates for CHP. CHP's policy is to remit all reinsurance recoveries received relating to claims arising from contracted facilities to such facilities. Reinsurance recoveries relating to out-of-plan claims are recorded as reinsurance recovery revenues. Reinsurance recovery revenues are reflected in the accompanying statements of revenues and expenditures and changes in fund balance as a reduction of medical care expenses. Beginning May 1, 1997 under the service agreement with L.A. Care, CHP no longer has reinsurance coverage. Reinsurance recoveries receivable was \$1,157,624 as of the year ended June 30, 1999.

**Income Tax** - As an operating division of the County, CHP is exempt from State and Federal income taxes.

**Use of Estimates** - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.



### **NOTE 3 – PREPAID CONTRACT COST**

During fiscal year 1997, CHP paid \$1,000,000 as start-up contribution to L.A. Care under its service agreement. The amount is recorded as a prepaid contract cost and amortized over the life of the service agreement (three years). As of June 30, 1999, the balance of prepaid contract cost was \$277,772.

### **NOTE 4 – RESTRICTED INVESTMENTS**

In April 1997, the Board of Supervisors of the County of Los Angeles authorized CHP to purchase obligations of the U.S. Treasury in the amount of \$300,000 to comply with the security deposit requirements of Section 1300.76.1 of Title 10, California Code of Regulations. These investments are held by the County Treasurer in CHP's name and are assigned to the Commissioner of Corporations of the State of California. At June 30, 1999, the carrying amount of the U.S. treasury bills was \$303,167 which approximates market value. New U.S. treasury bills of a minimum value of \$300,000 will be purchased for deposit and assigned as the existing securities mature.

### **NOTE 5 – ESTIMATED MEDICAL CLAIMS PAYABLE**

Medical claims payable comprise of claims payable or pending approval, and a liability for claims incurred but not yet received. As of June 30, 1999, medical claims payable consisted of the following:

Claims payable/pending approval	\$ 5,771,274
Claims incurred but not received (IBNR)	<u>2,344,638</u>
	<u>\$ 8,115,912</u>

### **NOTE 6 – ACCRUED HEALTHCARE EXPENSES**

CHP has entered into service agreements with certain County and non-County hospitals and clinics to provide primary care, ancillary services and daily hospital services to enrollees for approximately 72% of the capitation premiums received by CHP for Medi-Cal enrollees. Such amounts are included in medical care costs in the accompanying statement of operations and changes in fund balance and totaled \$68,531,781 for the fiscal year ended June 30, 1999.

Accrued healthcare expenses comprised of the following as of June 30, 1999:

Accrued capitated expense	\$ 7,917,620
Reinsurance recoveries due to providers	1,157,624
Accrued excess healthcare expenses	<u>4,032,239</u>
	<u>\$ 13,107,483</u>

### **NOTE 7 – AMOUNTS DUE FROM (TO) OTHER L.A. COUNTY FUNDS**

CHP paid for general relief out-of-plan claims with service dates prior to October 1, 1995 and the related general and administrative costs. CHP also pays certain in-plan claims on behalf of a County health facility. These expenses are reimbursed by the County. Certain costs paid by the County on CHP's behalf are reimbursed by CHP. The amounts due from and (due to) other L.A. County funds are \$238,508 and (\$6,139,880), respectively, as of June 30, 1999.

## **NOTE 8 – RETIREMENT PLAN**

The County's retirement plan covers CHP employees and provides for monthly pension payments to eligible employees upon retirement. Salaries and employee benefits expense includes a provision for the retirement plan cost, as well as vacation and sick pay, which is estimated based on a percentage of salaries expense. The actual cost of the retirement plan, actuarial present value of accumulated retirement plan benefits, and net assets available for retirement plan benefits are not separately identifiable for CHP.

## **NOTE 9 – CONTINGENCIES AND SUBSEQUENT EVENTS**

### **Risk Management**

The County has agreed to fund CHP losses, if any, and to cover CHP under its self-insured medical malpractice program when medical services are provided at a County facility. In addition, the County has agreed to cover CHP under its self-insured worker's compensation program. These coverages are provided to CHP at no cost.

### **Non-Compliance with Health and Safety Code**

On May 14, 1999, the State Department of Corporations ("SDOC") found, among other things, that the Plan had arrearages of \$8,464,049 on provider claims and did not accrue or pay interest on any unpaid claims. On July 8, 1999, SDOC, following its on-site reviews of the Plan's operations, determined that the Plan was still delinquent in adjudicating and settling many of the claims examined on the prior audit. On September 9, 1999, SDOC issued two separate cease and desist orders arising out of the above audit and on-site reviews. Each order directs compliance with statutory or regulatory rules, as construed by SDOC, within ten (10) business days of the date of the order or be subject to administrative penalties of \$2,500 per day, beginning the eleventh business day. In October 1999, SDOC performed another on-site review. At the same time CHP has taken necessary correctional actions in response to the SDOC's orders and recommendations. As of November 5, 1999 the administrative penalties have been put on hold and the ultimate resolution of such event is not ascertainable. No provision has been made in the financial statements related to the event.

### **Claim Processed on Behalf of Healthcare Providers**

As discussed in Note 2, CHP processes claims on behalf of certain capitated healthcare providers. In addition, CHP prepaids claims in order to meet certain California health and safety codes regarding timeliness of claim processing. CHP records these claims processed as accounts receivable and prepaid medical claims, and expects reimbursement from these healthcare providers for their portion of liability. Accounts receivables and prepaid medical claims amounted to \$13,217,301 at June 30, 1999. Management believes that the uncollectible amount, if any, will not be material to its financial position.

**NOTE 10 – PRIOR PERIOD ADJUSTMENTS**

Certain errors resulting in the over statement of both liabilities and expenses of the prior year were corrected this year. The changes to fund balance as of June 30, 1998 and net income for the year then ended are summarized as follows:

	<u>Fund Balance</u>	<u>Excess of Revenues Over Expenses</u>
As previously reported	\$ 3,614,798	\$ 13,665
Overstatement of salaries payable from June 30, 1997	322,655	-
Overstatement of accounts payable from June 30, 1997	506,568	-
Provision for incurred but not reported claims duplicated in error, June 30, 1998	<u>2,015,000</u>	<u>2,015,000</u>
As adjusted	<u>\$ 6,459,021</u>	<u>\$ 2,028,665</u>